Payment Instruments and Collateral in the Interbank Payment System

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Abstract

This paper presents a three-period model to analyze why banks need bank reserves despite the presence of other liquid assets. The model highlights the fact that the interbank market is an over-the-counter market. It implies that the large value payment system at the central bank is an implicit contract to save liquidity for the settlement of bank transfers. In this contract, bank reserves are the balances of collateral and the central bank is the custodian of collateral. The optimal contract is the floor system. A private clearing house cannot replace the central bank unless it can commit to time-inconsistent behavior.

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